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DISCUSSION PAPERS

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Central-Local Fiscal Relations in Low-Income Countries: The Case of Nepal

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Abstract

Maintaining the proper equilibrium between centralized and localized fiscal management is a dilemma facing the low-income developing countries today. More decentralization is desirable in order to supply the right mix of public services that are needed by the diverse regions. At the same time, the very great differences in the level of development and growth rates of the major urban areas compared with the countryside require very different levels of resource mobilization. In the poorest developing countries, the central government is usually the only level of government that has the capability of generating the resources needed by the expanding urban areas and in turn is the only level of government that has the capability of planning for the delivery of services in the rural areas.

In Nepal, the Local Self-Governance Act of 1999 has expanded both the functions and revenue authority of the local governments. It will not be easy to translate theory into practice. Decentralization will require strong political will, and an improvement in administration and support from the central government (particularly in the case of rural local governments), if it is to succeed.

Background

Governments exist in countries at the national as well as subnational levels. The number and the structure of the subnational governments depend upon the system of government adopted by the particular country in question. Generally, under a federal system, subnational governments exist at the state, provincial, and local levels, while under a unitary system, subnational governments exist at the local level only. For example, India has adopted the federal system, where there are two tiers of subnational government: state and local. On the other hand, Nepal has adopted a unitary system, where there is only one tier of local governments. There are, however, exceptions. For example, while Indonesia has adopted a unitary type of government, it has provinces (Kabupatens/Kotamadyas) and villages.

There is a case for every level of government. For example, since individual preferences vary in different regions of a country, there is a need for local governments that can provide the mix and level of service to reflect the different preferences of the local people. This enhances economic efficiency. Higher levels of government also play an important role in cases of regional spillovers and economies of scale. If the benefits or costs of local expenditure are spread outside the local areas, the local governments will spend too little. They will simply ignore the benefits received by people outside of the local jurisdiction, leading to a situation of underutilization or overconsumption. Higher levels of government can develop policies to minimize these distortions. In addition, higher levels of government can provide for economies of scale in the provision of certain public goods and services.

D. A. Auld, reflecting on the international experience of central-local fiscal relations concluded that "Transcending any political and historical forces that have shaped local governments there exist sound reasons, based on certain principles of political economy, for the existence of independent local public sectors, even in so-called unitary states. Decentralization theorems have demonstrated the possibility of welfare gains to be derived from the existence of such smaller public sectors, while other studies have indicated how efficiency gains may be realized from decentralized provision of public goods."[1]

There has been an increasing focus on strong local government in various countries, including low-income countries. Generally speaking, local governments are weaker in low-income countries than in the high-income countries. It is said that "the weakness of local government in relation to central government is one of the most striking phenomena of underdeveloped countries."[2] The view has also been expressed that "it is economic development that comes first; fiscal decentralization then follows."[3] In general, it appears that governments in the low-income counties are far more centralized (as measured by existing fiscal indices) than in the high-income counties.[4]

Attempts have been made to strengthen local governments in Nepal, where these bodies have been created in one form or another since the early 1960s. They are constituted with elected representatives. They exist at the district and the village/municipal level. Currently, there are seventy-five District Development Committees (DDCs), covering fifty-eight municipalities (major urban areas) and 3,913 Village Development Committees (VDCs). Municipalities exist in urban areas, while VDCs are created in the rural areas.[5] The Local Self-Governance Act of 1999 has expanded both the functions and revenue authorities of the local governments and has created an opportunity for the establishment of local self-government in Nepal. It has paved the way for promoting democracy at the local level.

As in many low-income countries, the fiscal systems of local governments in Nepal are still in a state of infancy, reflecting a very centralized system of public finance in the country. The central government has played the dominant role in expenditure and revenue decisions. The central government is responsible for stabilizing the macroeconomic environment and securing the finances for development expenditures, and shoulders the major share of the allocation functions of government. The central government collects and spends more than 90 percent of total government revenues and expenditures, while the local governments' budgetary position is very weak, as illustrated in Table 1.

Table 1. Status of Public Expenditure and Revenue in Nepal in 1997/98
(Rs in 1983/84 prices)

Descriptions	***Rs in millions***	
Total Expenditure		**16,686**
Central Government	15,167	
Local Governments	1,519	
Total Tax Revenue		**7,464**
Central Government	7,011	
Local Governments	453	
Total Nontax Revenue		**2,500**
Central Government	1,891	
Local Government	609	
Total Grants		**2,192**
Central Government	1,460	
Local Governments	732	
Total Loans		**3,911**
Central Governments	3,906	
Local Governments	5	

The fiscal position of the local governments in Nepal is far from satisfactory. Local governments have been authorized to levy only a few taxes. They do not collect even these taxes. Local governments have not exploited their fiscal potential. They depend on central government transfers to meet their expenditure needs. They do not carry out most of the functions assigned to them. While the Local Self-Governance Act of 1999 has expanded both the expenditure and revenue authority of the local governments, the governments find it difficult enough to formulate plans and programs and execute them without even generating revenue. Experience elsewhere also indicates that "even if local governments are assigned clearly defined functions and have the means to finance these functions, local political leadership will not necessarily respond to the interests of their constituents (or to the central government) unless a balanced system of accountability is in place."[6]

This paper focuses on the central-local fiscal relationship in the context of low-income countries, with special reference to Nepal.

Central-Local Fiscal Relations[7]

Central-local fiscal relationships reflect the respective allocation of expenditure and revenue responsibilities between the central and local governments. Within the framework of enabling government to provide macroeconomic stabilization, distribution, and allocation, there is considerable agreement among public finance experts that the central government should be responsible for the stabilization and distribution functions, while both the central and local governments should be responsible for the allocation functions. Local governments can provide public services more efficiently in their "benefit areas," since they can respond more quickly and appropriately to changing local conditions than can central government.[8] On the other hand, central government can provide those public services more efficiently when there are economies of scale and interregional externalities.

Attempts have also been made to allocate revenue instruments to the central and local level governments to:

- provide sufficient revenues to the central government for managing the macroeconomic stabilization functions;
- provide sufficient revenues to the central government to achieve its redistribution functions; and
- provide sufficient revenues for the central and local governments to achieve their objectives of generating efficiency and providing essential government goods and services.

There is broad agreement among public finance economists regarding the division of tax authority between the central and the local governments, as follows:

- Taxes, which are suitable for economic stabilization, should be retained at the central level, while local taxes should not be much affected by business cycles.
- Progressive taxes, which are a function of taxpayers' overall level of income, should be retained at the central level.
- Unequally distributed tax bases should be taxed at the central level in order to avoid magnifying inequalities.

- Local governments should have tax bases with a low mobility between jurisdictions in order to avoid locational distortions and tax exporting.
- Both the central and local governments should put into place benefit taxes and user charges.

These broad guidelines lead to the following indicative distribution of revenue bases by level of government:

Central level revenue sources

- international trade taxes
- corporate income taxes
- personal income taxes
- value added taxes
- natural resource taxes
- user charges

Local level revenue sources:

- property taxes (e.g., real estate)
- vehicle taxes/toll tax on local roads
- limited commodity taxes, such as entertainment taxes, frontage taxes, and taxes on fairs and market places
- user charges

These possible combinations of revenue allocation methods allow countries to obtain the benefits of fiscal decentralization—achieving local accountability and efficiency in allocation with some "local taxes," while enabling the country to realize its macroeconomic stabilization and redistribution objectives with some major central government revenue sources.

In combination with the allocation of expenditure responsibilities, the allocation of revenue among levels of government creates an economic and political dilemma for all countries, because there are clear economic (and also administrative) advantages for centralizing the major and most buoyant tax bases, while there are major economic advantages of decentralizing important, but often costly social and infrastructure service expenditures. This economic logic for distributing revenue and expenditure responsibilities between the central and local governments tends to create two basic problems:

> *Problem of Vertical Imbalance*. This problem occurs when the expenditure and revenue responsibilities and amounts are unequally divided between the levels of government. The major cause is that the larger, most buoyant taxes are more efficiently and equitably administered at the central level, while many of the more costly services are better administered at the local level.

Problem of Horizontal Imbalance. This problem occurs when there is inequality among local governments in terms of their ability to mobilize revenues and distribute costs. The major causes are the unequal location of the revenue sources, the differential ability to mobilize revenues from these sources, the differential expenditure needs and costs of service provision and the differential ability to provide these services. These differentials create inequities among local governments.

These problems necessitate that the government carefully evaluate the expenditure and revenue needs of central and local governments and ultimately combine the assignment of independent revenue sources (and possible surcharges on national-level tax bases) with a broader revenue allocation system consisting of tax sharing and/or revenue sharing to offset the natural gaps and imbalances that must, by necessity, exist.[9] Grants and loans are also used as a means of providing financial resources to fund public functions at the local level.

Allocation of Basic Economic Functions

National and subnational governments carry out economic functions that are commonly divided into three groups: stabilization, distribution, and allocation. Among the three functions, stabilization is the one that is entirely central. "It is customary to argue that the federal government should be responsible for stabilization policies because such policies cannot be carried out effectively by a local jurisdiction."[10] For example, monetary policy is implemented in all countries by the central government, not by local governments.

Distribution functions are also basically central in nature because "people bearing the burden of distributional policies might migrate and thus render local distributional policies inefficient."[11] However, local governments also can be involved in the provision of "distribution" services but the funding should come from the central government.

The allocation function should be the core function of local governments[12] although central governments can also play a role in the allocation function. Local governments are more effective in achieving allocation efficiency, since they can better respond to people's preferences and deliver public services at a lower cost. Similarly, due to geographical realities, it is difficult for a central government to reach the grass root level in an effective manner. The supply of the same public good provided by the central government may not match the demand of the local area, leading only to economic inefficiency. According to the Tiebout model "the most efficient allocation of public sector resources can in principle be secured only if such services are provided (and paid for) by governments responsible to those most directly affected."[13]

Local governments are authorized to carry out typical community functions, such as public health, sewerage, refuse collection, refuse disposal, schools, maintenance of local roads, etc. Local government functions can be classified into three groups:

(i) General services: refuse collection, parks and recreation, fire protection, and other miscellaneous services

(ii) Public utilities: water supply, sewerage and drainage, electricity, telephones, housing, markets, and public transportation

(iii) Social services: education, health, and social welfare

A list of functions of the local governments in urban areas with moderate responsibility is given in Appendix 1. In Nepal, the Local Self-Governance Act of 1999 has assigned many functions to the local governments. These are given in Appendix 2.

Basic Revenue Allocation Options

Fiscal autonomy is a key for the establishment and development of local self-government. It is important that the local governments have adequate resources to carry out their functions. To this end, local governments should be authorized to use several sources of revenue. It is believed that the tie between raising revenues and making expenditures encourages more careful decisions about the overall level and composition of public activities desired by a local government.[14] There is also the argument that dependence on the central government for money (and not having local-government revenues) reduces autonomy and creates dependence—thus breaking the link between accountability and efficiency.

One question that may arise here is whether or not small villages and big municipalities should be assigned the same mix of revenue sources. "Though some modifications may be necessary for small and remote places due to their lack of tax collecting ability, generally a local tax system should be the same for all local governments. . . . If the tax mix is very different between types of cities, villages etc., a local government will strive for more tax reasons to become bigger, and people and businesses make their locational decision for tax reasons instead of under economic considerations."[15] This problem appears particularly when small villages and big municipalities exist side by side. This has happened in Nepal, where even small villages were converted into municipalities, under political pressure, in order to make use of the authority of levying the octroi, a tax given to the municipalities only. This indicates the need to give similar tax authority to all local governments, irrespective of their size.

Local governments should be authorized to collect nontax revenues. They should use a system of user charges (e.g., water, garbage collection, market fees, etc.) if it is possible to identify the beneficiary. Local governments should then go to taxes, which should be used when the beneficiary cannot be identified and/or when there are tremendous administrative and economic costs involved when trying to collect user charges from the beneficiary. They should be allowed to levy such taxes that can be collected efficiently at the local level. In addition to independent local taxes, there are different ways of collecting tax revenues, including the addition of a local government surcharge on already existing central government taxes, tax sharing, and revenue sharing. In addition, they should also get grants from the central governments, and have the option to borrow money to carry out their functions. These options are examined below:

Taxes

Such local services as general local administration, traffic control, street lighting, and security, whose primary benefits accrue to the local population but where the exclusion principle in pricing cannot be applied, should largely be financed by taxes.[16] For this, local governments should be given the authority to levy and collect their own taxes. This promotes autonomy, since revenue from these taxes can be used freely by the local governments. Local taxation rights should also promote accountability so that expenditure decisions somehow are reflected in the tax bill to be presented to the electorate.[17] "Lack of local taxation tends to reduce the sense of responsibility in local government politics. Local politicians can put the blame on central government grants for not meeting excessive demands for better service."[18]

There are five methods of tax revenue allocation: independent local taxation, centrally assisted local taxation, surcharges on national taxes, tax sharing, and revenue sharing. It is important to distinguish among those methods that give local governments some policy discretion (i.e., independent local taxation, centrally assisted local taxation, and surcharges on national taxes) and those that are essentially revenue transfer programs (i.e., tax sharing and revenue sharing). The independent taxes, centrally assisted local taxes, and the surcharges can be called "local taxes," while the other two options are essentially revenue transfers.

International experience suggests a wide variety in the allocation of these revenue instruments among levels of government. The exact combination of the allocation options depends on the specific historical and institutional environment, the degree of trust between levels of government, the relative importance of local autonomy, the level of duplication, the compliance and administration costs for labor and businesses, and the need for equalization. However, countries typically use a combination of the various allocation options, mixing independent local taxes, centrally assisted local taxes, and local surcharges with either tax sharing and/or revenue sharing among the levels of government. The individual policy and administrative structures for revenue instruments is shaped by factors such as revenue potential, economic efficiency, equity, administrative feasibility, and political acceptability. It is the effective combination of the policy and administration that ultimately determines the success of the local government revenue system.

Independent Local Taxes

Within the framework of developing an appropriate revenue allocation structure, it is common for countries to first allocate specific tax bases as "independent local taxes." It is hoped that these assigned tax bases (accompanied by proper policy and administration) will provide enough revenue for at least the richest local governments to finance their local services (excluding those local services with large externalities).

Under this system, local governments have some control over bases, placing the policy, administration, and revenue within broad guidelines set by the central government.

The major advantage of such a system of independent local taxes is that it provides choice and control to the local authority for policy matters (e.g., tax base and tax rate) and administration. This autonomy over the control of local revenue increases the accountability of the local authorities over the citizens, since those paying taxes will demand accountability in terms of service delivery. The autonomy also increases the economic efficiency of the local government, since it has control over increasing levels of local revenue to finance higher levels of services in accordance with the tastes and preferences of its citizens. Possible disadvantages of this option may include the duplication of administration, increased administration/compliance costs, and possible inter-regional distortions from different tax bases and tax rates. This option alone allows no equalization in the absence of other revenue allocation methods.

Centrally Assisted Local Taxes

The provision of centrally assessed local taxes gives an independent tax base to the local government, allowing the local government to retain the tax revenue and policy discretion. It, however, allows for the central government to "co-administer" certain aspects of the tax administration (e.g., tax base identification, valuation, assessment, collection, enforcement, and appeals).

The advantages of this option are that it minimizes administration and compliance costs by benefiting from economies of scale and minimizing transaction costs for compliance. In addition, it may "de-politicize" certain aspects of tax administration, possibly increasing the equity of the system. Local governments maintain control of their policy and revenues, but depend on the central government to assist with such aspects as property information management, property valuation, tax collection, and enforcement. Once again, however, there is no equalization in the absence of other revenue allocation methods. In addition, there is a possibility of inter-regional distortions from differential tax bases and tax rates.

Surcharges

This system allows the local governments to set a rate on the centrally determined and centrally administered tax rate. Revenues collected from this surcharge are given back to local governments either by point of collection or taxpayer residence.

The advantage of this option is that it minimizes administration and compliance costs by having a uniform tax base and uniform administration. Although the local authority has no control over the tax base (which is determined by the central government), it retains some control over the tax rate. In this case, the local authority has access to the more buoyant tax bases normally reserved for the central government. The extent of this access depends on the surcharge rate chosen by the local authority.

Under this system, local authorities do not have control over the tax base, and local revenue falls with changes in the rate of central tax. There is no equalization in the absence of other revenue allocation methods.

Tax Sharing

Since local governments are generally authorized to levy less-buoyant taxes that are not capable of generating revenue to meet their increasing expenditure responsibilities over time, they may be given a share in one of the more buoyant taxes lying under the jurisdiction of the central government. Under this system, various levels of government share the revenue collected from the individual taxes.[19] Generally, the central revenue administration collects specified taxes but transfers a given percentage automatically to the other level of government, which in turn is divided among the local governments on the basis of certain formulae.

A tax-sharing system maintains all policy and administration under central government control, but gives a portion of the revenue collected from a particular tax to local governments—based either on the point of collection, the location of the taxpayer, or some other formula.

The advantage of this system is that it minimizes economic, administration, and compliance costs by having a uniform tax base, uniform tax administration, and uniform tax rate. Once again, tax sharing allows local governments to access revenue from the more buoyant tax bases normally reserved for the central government. It is predictable and, in this sense, is preferred to grants.[20]

The disadvantage is that the local authorities have no control over the tax base, the tax rate, or its administration, thereby losing the advantages of accountability and economic efficiency in matching expenditures and revenue. Since tax rates of shared taxes become uniform among local governments, there is less autonomy. If a large part of the tax is transferred to another level, there is less incentive for efficient tax administration by a responsible level of government. This option does not allow for equalization, unless the revenue is allocated on the basis of a formula.

General Revenue Sharing

General revenue sharing maintains all policy, administration, and revenue under central government control, but shares collected revenue from a broad group of taxes with the local governments according to a formula. Tax proceeds are shared among various levels of governments. One level of government has unconditional access to a specified share of revenue collected by another level. Generally, national governments collect tax and provide the share of subnational governments.[21]

The advantages of this system are that it minimizes economic, administration, and compliance costs by creating a uniform tax base, tax administration system, and tax rate. Once again, it allows the local government access to revenue from the more buoyant tax bases, which are normally reserved for the central government. In addition, revenue sharing is distributed on the basis of a formula, which allows for equalization. Revenue sharing is used to bridge a fiscal gap, promote fiscal equalization and regional development, and stimulate tax effort at lower levels.[22]

This system, however, does not provide the local authorities with any discretion over the tax base, the tax rates, or administration, thereby losing the advantages of accountability and economic efficiency through matching expenditures and revenues.

Selection of Taxes and Their Structure

It is necessary to select appropriate taxes for the local governments and to design their appropriate structure. Local governments should be allowed to levy taxes whose character is local by nature. Property taxes, frontage taxes, vehicle taxes/tolls on local roads, taxes on fairs and markets, poll taxes, and entertainment taxes are generally considered local taxes.[23]

Property taxes provide the major source of revenue for local governments in many countries. The property tax is a representative example of a good local tax, since it satisfies most of the necessary criteria. For example, property taxes provide for autonomy in local taxation, providing local governments with some authority to fix tax rates according to local conditions. Variation in the rates or bases of property taxes are likely to cause fewer distortions in the economy than would similar variations in income and commodity taxes. Resources are not likely to be diverted due to a differentiation in property taxes, unless the bases and rates vary widely among the local governments.

In response to this, central governments generally fix the minimum and maximum rates, and local governments determine rates according to their needs within these limits. Some governments fix maximum rates only, while some others fix minimum rates only. There are other reasons for the central government's fixing of the minimum and/or maximum rates. For example, a local government might levy unrealistically low rates in order to gain favor among its citizens. To prevent this, some governments fix minimum rate levels. Some poorer local governments try to generate more revenue from their property taxes by levying higher rates, with the intent of generating more revenue. At the same time, the government might not put enough effort into enhancing its tax base or improving its administration. The end result penalizes those who happen to be under the tax net. They are forced to migrate to other areas where the tax rates are lower. This process is self-defeating in the end. To avoid this situation, the central government should fix a maximum ceiling on the tax rates.

Property taxes also provide a high degree of accountability because they are visible to the taxpayers. The base of the property tax is localized. It is usually clear which local government is entitled to tax a particular property. A local profit tax, for example, lacks this advantage.[24] The property tax is an appropriate tax system for application at the local level, due to the fact that its taxable base is the one that is most capable of being localized and, therefore, most easily controlled by the local authorities.[25] Property taxes levied on local residents are unlikely to be exported. The burden of the property tax is visible and increases taxpayers' awareness.

Property taxation is, however, politically sensitive. It may not be attractive to some politicians. For example, the property tax has not been attractive for local-level politicians in Nepal. In this context, attempts might be made by the central government to fix minimum standards for fiscal performance, which would make the imposition of the property tax mandatory. In the beginning, local governments could start with minimum rates. Revenue generated from these taxes should be used for the activities that benefit local people immediately. Once local residents visualize the benefits of the tax, they will be encouraged to comply with payment of the tax. Then the rates can be increased gradually.

While taxes on mobile factors such as corporate and personal income taxes and multistage sales taxes (such as the value added tax),[26] are politically less controversial than property taxes, they are not appropriate at the local level. This is due to the fact that since individuals are more mobile than property, income tax differentials will lead to a flight of income from the high-tax jurisdiction.[27] This is also true in the case of broad-based commodity taxes that would bring about distortions in the economy. This means that local taxation on incomes and commodities would induce shrinkage in the tax base and would therefore inflict serious injury on the local economy. Knowing this, local governments are not generally enthusiastic about implementing such taxes.[28]

Furthermore, it is administratively difficult to implement some of these taxes at the local level. For example, imposition of the corporate income tax at the local level would require a segregation of profit of a corporation by local government area, which would be very difficult. Similarly, imposition of a broad-based commodity tax at the local level with varying rates among local governments would complicate tax administration unacceptably. Further, the corporate income tax can be quite cyclical in its flow of revenues, which is not desirable if the local governments are responsible for essential public services.[29]

This indicates the need to assign taxes on mobile factors of production or on bases that are unevenly distributed over space or progressive taxes to the higher levels of government.[30] Local governments in Scandinavian countries, however, generate the bulk of their revenue from income taxes, which have been administered together with the central-level income tax. Similarly, in Germany, local governments collect 15 percent of the wage tax and assessed income tax, while the remaining 85 percent is divided equally between the federal and the lander [state] governments. Income tax is shared with local governments in the CIS countries also.The local income tax could be levied either in the form of a centrally administered tax, or a surcharge, or as a shared tax. However, it could not be justified as an independent local tax, since it would be a burden not only on the taxpayers, but on the tax administration as well. In Japan and Thailand, the central and local governments share the value added tax. Since the local governments do not have the administrative capacity and cannot efficiently collect such taxes at the local level, they are collected by the central government and shared by the local governments.

Application to Nepal

As stated earlier, in general, local governments are weaker in low-income countries compared to high-income countries. Among the local governments, the rural governments are the weakest. They lack the administrative, technical, and managerial capabilities to run local affairs properly. Local governments provide very few public services to their citizens. They are also constrained by their revenue bases. Local governments in the urban areas, on the other hand, which have been growing fast, do have bigger potential tax bases. Furthermore, the demand for modern public services is very high in these areas, a fact that puts pressure on them to generate additional resources. Establishment and reform of the revenue system at the local level in the low-income countries implies putting priority on the establishment and reform of revenue systems in the urban areas. Local governments in the urban areas can manage their local affairs, including the management of the fiscal system properly, if they wish. This is not feasible in most rural areas. There is a big difference between the capacity of rural and urban local governments.

Existing Nepalese Scenario

The application of local government revenue measures to Nepal should be seen in its existing geopolitical and economic situation. While Nepal may represent an extreme example of conditions found in a poor developing country, it does illustrate the constraints such conditions impose on the theoretical ideal of central-local fiscal relations. Nepal is a mountainous county, where many local governments exist in remote, rural regions. At the same time, there are a few relatively modern urban areas. The villages are scattered all over the Himalayan kingdom. In several places, there are only a few houses and it take hours to travel from one settlement to another. The quality of the infrastructure is poor. There are not even adequate rural paths to walk on, and no electricity and water supply. The only means of lighting is the oil lamp, and sources of heating are firewood or cow dung. Water is collected from streams. Good schools and health centers are also in very short supply.

While there is a severe lack of almost all modern public services in the rural areas, there is at the same time little demand by the people for such services. As a result, there is no pressure for more financial resources. In fact, several VDCs do not even spend the annual grant of Rs 500,000 provided to them by the central government. Local government institutions are not well established. It may not be surprising to find a VDC chief who cannot even read and write. In several VDCs in the rural areas, there is only one village secretary who is a central government employee and generally remains absent from his office. The VDCs do not have even a general idea of how to administer a local tax system and lack the technical capabilities to implement such taxes. As a result, they make limited use of any of the methods of revenue collection. At the same time, the local tax base is narrow. The base of such modern taxes as the vehicle tax, entertainment tax, and advertisement tax often simply does not exist.

While the cities in Nepal are few, they have been growing very fast due to rural-urban migration. The demand for such public services as drinking water, sewerage, road maintenance, garbage collection, electricity, street cleaning, and pollution control is very high. This means that there is tremendous pressure for more financial resources, which must be generated through a combination of increased local revenues, grants, or even loans. However, the tax administration in Nepal is very weak at the municipal level. Local administration does not attract as many employees as does the central administration. There are fewer promotion opportunities and there is less job security in the local civil service than in the central government civil service. As a result, most of the taxes assigned to the local governments[31] are either not implemented or, at best, not effectively tapped. While the Local Self-Governance Act of 1999 has enhanced the tax authority of the local governments,[32] the potential will remain unrealized if substantial efforts are not made to improve the capability of the local tax administrations.

Table 2 describes the status of local tax revenue collected in 1997/98. This shows that local governments, excluding municipalities, have not made any effort to collect tax revenue, despite the fact that they have been authorized to levy several taxes.

Table 2. Status of Local Tax Revenue (1997/98)
(Rs in 1983/84 prices)

Local Governments	*Tax Revenue (Rs in millions)*
DDCs	11
Municipalities	266
VDCs	176

While municipalities have been generating some tax revenue, they had relied heavily on the octroi (a tax collected by municipalities at the city gates at the rate of 1 percent of the value of goods entering into a municipal area). Other taxes are yet to be developed at the municipal level. This can be seen from Table 3.

Table 3. Composition of Municipal Tax Revenue
(Rs in million of 1983/84 prices)

TAXES	1994/95	1995/96	1996/97	1997/98
Octroi Tax	177	174	165	223
Vehicle Tax	17	17	17	27
Professional Tax	3	2	3	5
Roof Tax	-	-	-	1
House Rent Tax	-	-	-	-
Others	3	5	8	10
Total Municipal Taxes	200	198	193	266

Note: A dash indicates that the amount is negligible.
Source: UDLE, "Detailed Revenue and Expenditure Breakdown and Basic Financial Information of 58 Municipalities of Nepal (FY 1994/95–1997/98)," Urban Development through Local Efforts, Kathmandu.

Municipality revenue needs have been met historically by the octroi, which was an easy and buoyant source of revenue of the local government. However, in April 1999, this octroi was abolished because it is an economically inefficient tax from a national perspective. One of the important problems for Nepal now is how to develop a viable alternative to the octroi both over the short and long terms. While the Local Self-Governance Act of 1999 intends to develop the property tax as a major source of local government revenue, it cannot be developed overnight. It will take some time. An alternative source of revenue needs to be developed immediately to compensate for the abolition of the octroi. The property tax will not be adequate to compensate fully for the abolition of the octroi even in the long run. Therefore, it will be necessary to develop other sources of local revenue to supplement the property tax. The central government has introduced a 1.5 percent local development tax on imports as an immediate substitute to the octroi. As discussed later on, like the octroi, the local development tax also suffers from several limitations. So there is a need to develop other more suitable and viable taxes, such as the motor fuel tax and vehicle tax, as revenue sources for financing municipal expenditures.

Local Tax Issues

Property Taxes

Unlike many other countries, local governments in Nepal have not been depending upon the property tax as a source of revenue. While the Local Self-Governance Act of 1999 intends to develop property-based taxes as the major source of local government revenue, the central government continues to levy some property taxes such as the land revenue tax (collected by the local governments since 1996), and the house and the land tax. Under the Local Self-Governance Act of 1999, local governments are also entitled to levy land revenue and the house and land taxes. Hence, overlapping authority is given to the different government levels to levy property taxes. Furthermore, their administration is not coordinated.

The property tax, levied as the land revenue tax, has been the traditional source of revenue of the central government in Nepal. Land taxation has been levied at the central level for a very long time. It is operated under the central government's Land Revenue Act. It was and still is levied on each parcel of land. Tax rates are fixed on the basis of land area. For the purpose of fixing land revenue rates, land is divided into four categories in the rural areas, depending upon its productivity, and six categories in the urban areas, depending upon its commercial importance and the availability of facilities.

The land tax was the major source of central government revenue until the 1960s. This source used to generate about 40 percent of total tax revenue until the 1950s and 25 percent until the 1960s. Since the 1970s, however, rates for this tax, which are specific, have not been increased for political reasons. At the same time, several exemptions have been granted for small farmers. As a result of this and the emergence of other more buoyant taxes, such as the sales tax and the income tax, the relative importance of land revenue has been decreasing. The contribution of land revenue declined below one percent in the 1990s from about 40 percent in the 1950s.

In 1996, land revenue collection power was transferred to the local level. The Land Revenue Department transferred all administrative functions for the tax to the local government. Related to this, records on land-ownership were handed over by the land revenue offices to the VDCs or municipalities. Currently, revenue collection is supposed to be done by the VDCs/municipalities. The VDCs/municipalities keep 75 percent of the land revenue proceeds and must transfer 25 percent to the DDCs.

The transfer of the collection function of land revenue to the local bodies has created several transitional problems, since the transfer was implemented immediately and without adequate preparation. No procedures were set down for the transfer and collection of land revenue by the local bodies. Local government personnel were not trained, and indeed, in some of the remote areas, there was no staff available to be trained. Many VDCs lack the capacity to administer land revenues effectively.

Furthermore, there is no coordination between local bodies and the land revenue administration. Local governments have little political incentive to collect land revenue since the tax burden is felt directly by the local people. On the other hand, the central government land revenue administration is not happy having lost their previous functions. The local people are also skeptical about the proper use of the land revenues by the local government bodies, although the land revenue tax is the oldest tax and is generally well accepted by the Nepalese people. The tax receipt issued by the land revenue offices was considered proof of land ownership, and the tax was paid without hesitation. The local people, however, do not attach the same importance to the receipts issued by the local bodies. This means that there is a risk of reduced taxpayers' compliance if local bodies do not link the land revenue proceeds to benefit the local people. The existing rate structure is unnecessarily complicated, and the rates of tax are very low. Exemptions provided for small farmers also cannot be justified.

Local governments, as well as the central government, have never issued a tax bill, but rather rely on taxpayers to voluntarily come to the government office to pay. It must be remembered that the property tax is an officially assessed tax. This job could be performed more efficiently by one land revenue office of the central government in one district than by hundreds of unorganized VDCs and municipalities. One option for the future would be for the land revenue offices in the districts is to issue tax assessments or the list of landowners and their holdings and send that to VDCs and municipalities, which should collect the land tax. The central government will need to continue to maintain records of house and land ownership, for various reasons, including the fact that the administrative capabilities of the local bodies are inadequate and the fact that they do not always exercise their authority properly. At the moment, local governments should put their effort into making sure that revenue is collected accurately.

Furthermore, the land tax would work better if it were tied to land records. Land ownership is basically the only thing that would change. The nature, type and size of the land would all remain pretty much the same. Once the land records were computerized and entered into the system, it would then be a simple matter to adjust for changing land values due to inflation and development over time and to issue the tax bills on a large scale.

In the past, local governments were allowed to levy property-based taxes in Nepal. For example, municipalities were authorized until April 1999 to levy a type of property tax on building in the name of "house roof tax." It was not attractive for them. As a result, it was not levied by several municipalities and had not been effective in those municipalities that levied it. This may be seen from the very poor relative position (0.20 percent of total tax revenue) of this tax in the municipal tax system. Local bodies have been unwilling to implement this tax for several reasons. Since the burden of property tax is highly visible to the public, local politicians think that they will not be re-elected in the next election if they implement this tax. They want to please their constituents by not levying a tax on houses. Furthermore, local governments lack proper records of buildings and administrative capability to implement this tax effectively.

There is still a case for a building tax at the local level. Local governments have better knowledge about the buildings in their respective areas. Local authorities know what is actually built in their areas. They could levy a simple tax on buildings, based on building type and area. Since buildings vary (in size, type, and quality) and since existing buildings are demolished and new ones erected, municipalities should not implement a complicated building tax that is based on the values of buildings.

If municipalities cannot levy the simple building tax, they can still derive revenue from the land tax. This would provide a rationale for keeping the land and building taxes separate.

Land Transfer Tax

The central government currently levies registration fees on the transfer of property. The base of the registration fees is the value of the property concerned. Land revenue offices fix land values. Such values are, however, much lower than current market values. Since these values are not reviewed on a regular basis, they get out of line with the market value. Property valuation is a big problem in many countries besides Nepal. This country lacks both the financial resources and the trained manpower for the proper valuation of house and land property, which is required by several organizations (including the land revenue offices, the tax offices, the department of housing and physical planning, the district administrative offices, and the banks). These organizations fix house and land values independently, resulting not only in a waste of scarce resources but also in considerable variation in the values of the same property. It would be preferable to have the value determined by a committee representing the affected concerned agencies, including the DDCs, and this value should be accepted for different purposes.

Tax rates (for example, 8 percent on property with a sale value of over Rs 5,000 in urban areas) are very high. High rates encourage the understatement of the value of the property. High official registration fees, combined with the unofficial costs typically associated with transferring land titles, hamper the efficient functioning of the land markets in Nepal, causing unnecessary delays and costs. High rates create distortions in the real estate market through the lock-in effect. Since a high registration tax hinders the development of the real estate, it is better to levy a much higher annual land and building tax instead of the high registration fees and to reduce them, instead, to 3 to 4 percent. Attempts should also be made to strengthen the annual property tax.

The Octroi

The revenue needs of the municipalities have historically been met by the octroi, which was relatively easy to collect. The ease of its collection may explain why municipalities have not been interested in property and other local taxes. The political officeholders preferred to collect revenue through the octroi, which was not directly felt by their voters and whose collection was easy to administrate. The octroi was very attractive from a revenue point of view, since it generated on average more than 80 percent of the total municipal tax revenue.

The octroi, however, was not an economically efficient tax. It was levied technically by using streetbarriers lowered and raised by tax inspectors. Together with the fact that this money was levied on out-of-town people and not on local constituents, the whole procedure reminded one of medieval robber-barons descending from their castles to collect "fees" from travelling merchants, than of a tax fit for a modern local government.[33]

The octroi did not satisfy most of the criteria of a good local tax and suffered from several practical problems. For example, the octroi did not promote accountability or autonomy, and it was exportable. It did not foster efficient resource allocation either. Vehicles were stopped at several points for the purpose of this tax, which not only created inconvenience to the importers, transporters, and passengers but also wasted time and energy and increased the cost of doing business. The free flow of traffic and trade was hindered. The octroi had more hidden costs than other taxes, such as property taxes. It was an economically inefficient tax from a national point of view. Consequently, this tax was abolished on April 29, 1999.

Local Development Tax

The local development tax has been adopted as a temporary revenue substitute for the octroi. This tax is collected at the customs points at the rate of 1.5 percent of import value, together with import duties. The local development tax seems to be easy for the municipalities and industrialists, businessmen, and transporters. It has improved the flow of vehicles and movement of goods (saving both time and fuel), prevented the octroi from being collected more than once on the same goods, and avoided the economic distortions caused by the octroi. It has also been a practical way to get money to offset the abolition of the octroi in the short run. However, since the local development tax is not considered to be part of the revenue targets of the customs officials, it is possible that over the medium term, there might not be an incentive for customs officers to collect this tax effectively at the customs points. In addition, this type of local development tax has several drawbacks.

- Local development tax deviates very much from the principle of local taxation.
- The method of collecting local tax at the customs points is itself not compatible with the principle of decentralization, which intends to develop local bodies as autonomous bodies. Decentralization cannot be successful in the absence of fiscal autonomy.
- Municipalities will not put any effort into strengthening their tax administration as long as they get revenue in an easy way from the central government through the local development tax.
- Municipalities may be encouraged to spend their revenue lavishly, since they do not have to put effort into the collection of the new tax.
- As this tax is levied on total imports, the incidence of the tax falls on all people living in both urban and rural areas. In that case, VDCs might demand a share of the new tax. This is likely to create political problems.

Municipalities are supposed to receive a share of the local development tax on the basis of their collection of the octroi in the past. It will be difficult for them to manage their affairs if they do not know, on a day-to-day basis, how much money is on hand and what they can expect to get next week. So attempts must be made to operate the local development tax distribution system effectively. This tax should be considered a temporary measure and should be phased out in four to five years.

Motor Fuel Tax

There is a case for a shared motor fuel tax. The motor fuel tax should be collected by the central government and revenues should be shared between the central and the local governments. This tax could be justified more as a benefit tax than the local development tax. This is due to the fact that a large part of municipal expenses are related to transportation. Since the demand for transportation services increases very fast in the urban areas, the motor fuel tax tends to be a buoyant tax. Since the consumption of motor fuel is basically concentrated in urban areas, the burden of this tax would largely be limited to the urban areas. Furthermore, the tax can be collected from a single public sector enterprise that is the importer of motor vehicle fuels into Nepal. Because of all these reasons, a motor fuel tax is considered a good tax to finance local governments' activities. In fact, from an economic point of view, there is a case for levying a motor fuel tax at a higher rate than the local development tax on all imports at the rate of 1.5 percent, in order to generate revenue for the municipalities. This shared fuel tax could be distributed to the local governments on the basis of certain formula, such as taking into account population, length of roads, etc.

Other Taxes

Local governments must also make an effort to establish and develop alternative revenue options. As stated earlier, the Local Self-Governance Act of 1999 has given them the right to collect various taxes. These taxes must be implemented. Central and local level vehicle taxes could be consolidated and levied at the local level. As the vehicle tax generates less than a half percent of the total tax revenue of the central government, its transfer would not cause much loss of central government revenue. Since vehicle ownership is easily ascertainable and the vehicle tax is levied basically on a per vehicle basis, registered within the jurisdiction of local bodies, this tax is easy to administer. In many countries, revenue is also generated through parking fees, either through parking meters or through attendants. This could generate revenue in a few municipalities located in Kathmandu Valley.

Other Measures

Local governments, particularly VDCs, do not have the expertise needed to administrator most broad-based taxes. It is therefore necessary to strengthen the local tax administration, assessment, and collection system. Local governments might need the assistance of the central government for some time. For example, such central government units as the district administration, police, and judiciary might help in enforcing local tax laws. Local governments also need to develop the political will to implement their power to tax. Political commitment is very necessary for an effective implementation of local taxes. Local leaders must understand that if they want to improve the economic well being of their communities, they need to generate their own revenue. They should not wait for the central government to provide grants. The new law has specified the rights and responsibilities of the local governments. It is time now to implement them.

User Charges

Local governments are also authorized to levy user charges, fees, and other nontax sources to meet their expenditure needs. Such public utilities as water, sewerage, power, telephones, and local transport, which are provided directly to individuals rather than to the community, can be financed by levying user charges.[34] The general principle should be to apply user charges where the benefits accrue to individuals within a jurisdiction consuming the goods and services and where the exclusion principle can be applied in pricing.[35]

It must be noted that user charges work as a means of rationing consumption for services. Since user charges can be varied with quantity, they can function as a pricing mechanism, confronting beneficiaries with a choice of different levels of services at appropriate prices, and allowing individual consumers to decide the quantity of a given service based on their preferences.[36] This ensures that the service will not be used excessively or carelessly.[37] User charges are thus an appropriate means of financing local services since they neither compete with higher-level government revenue bases nor are largely exportable. Further, they have desirable revenue, efficiency, and equity characteristics. They are also administratively feasible at the local level.[38]

Local governments in low-income countries are also often authorized to collect user charges and other nontax sources. Local governments in Nepal are no exception. For example, VDCs are empowered to levy several service charges and fees and can generate income through sales of goods and property. Like VDCs, DDCs are also empowered to levy service charges and fees and to collect revenue from the sale of local resources such as sand and stone. Similarly, municipalities are allowed to levy parking charges and various service charges. The nontax revenue situation of local governments in 1997/98 was as follows:

Table 4. Status of Nontax Revenue of Local Governments in 1997/98

Local Government Nontax Revenue (Rs in millions of 1983/84 prices)	
DDCs	65
Municipalities	86
VDCs	458

Grants

Grants play an important role in the fiscal system of the local governments in many low-income countries, where local governments cannot generate much revenue through tax or nontax sources. In these countries, many public functions of the local governments are financed by grants from the central governments. Grants are important in assisting the achievement of the distribution goals of the government across regions. They also help to achieve the objectives of the central governments in persuading local governments to administer national programs and to undertake expenditures that serve national interests.[39] Grants are justified on various grounds as follows:

- Grants are necessary and appropriate for activities that have distributional or benefit spillovers.[40] Such services as health, primary education, and welfare, for which substantial spillover occurs into neighboring jurisdictions should be financed largely by grants, since purely local financing would lead to underprovision of these services from a regional or national perspective.[41]
- Grants are given to equalize fiscal capacities or to equalize public service levels, since there are wide variations among local governments. A grant system, therefore, should try to provide a minimum level of public services. Large grants would be required for those areas whose tax base is narrow. Equalization grants are provided in order to guarantee a minimum level of standard services in all local areas.
- Grants are justified for the poorer regions that have a narrow tax base and a wide fiscal gap. Unfortunately, grants based on the size of revenue gaps encourage local governments to exaggerate expenditures or to reduce their effort to collect local taxes.[42]

In Nepal, as in many low-income and developing counties, grants from central governments to the local governments have been the major source of income, particularly in the case of the DDCs and VDCs. The transfer of resources from the central government to the local governments in the form of grants is given in Table 5.

Table 5. Grants from the National Government to the Local Governments

(Rs in millions of 1983/84 prices)

Local Governments	1996/97	1997/98	1998/99
DDCs	202	175	157
Municipalities	24	38	35
VDCs	521	519	495
Total Grants	747	732	687
Total Budget of HMG	14,252	15,167	14,461
Total Grants as % of Total HMG Budget	5.24	4.82	4.75

Sources: Economic Survey 2000; Red Book 1998, 1999, and 2000, Ministry of Finance, Kathmandu.

Local bodies receive grants in different forms. For example, DDCs receive grants from HMG that are earmarked under various names such as grants for the local development officer, grants for the VDC secretary, administrative grants, development grants, district road grants, and suspension bridge grants. Municipalities receive grants from both HMG and the DDCs. HMG grants are given in the form of administrative grants and development grants. Administrative grants are given to support HMG employees posted at the municipal offices, while development grants are provided to carry out development activities at the local level. Similarly, since 1995/96, HMG has been allocating Rs 200,000 to each ward in every municipality in order to carry out development activities in municipal areas. They also receive grants for fire prevention. Municipalities receive grants from the Town Development Fund Board as well.

Like municipalities, VDCs get grants from HMG and the DDCs, with HMG set to provide at least Rs 0.5 million as grants to each VDC each year from the fiscal year 1995/96. The grant system is not based on a scientific analysis of the need of the recipients. Large or small, developed or underdeveloped, rich or poor—all VDCs receive the same amount.

VDCs and DDCs depend largely on grants. Municipalities are in a better financial position than other local bodies, since they were receiving substantial revenue from the octroi. After the abolition of the octroi, municipalities are likely to get revenue through the local development tax. The low share of the grant in the municipal budget means that municipalities are financially more independent of the national government than are DDCs and VDCs.

Grants are viewed as an extreme form of centralization. In this respect, the Nepalese fiscal system is extremely centralized, since grants are distributed on an ad hoc basis. Among the local governments, particularly, the DDCs are uncertain about the funds they will get from the center. This is very critical at the district level, where almost all expenditure is met through the grants.

There is a need to develop formulas based largely on population and resource needs, for the allocation of a substantial proportion of the grants in order to avoid uncertainty, bargaining, and ad hoc negotiations. However, in low-income counties, it might be impossible to design grant formulas that would meet all or even a majority of the requirements for grant financing from the central government. In the context of fiscal decentralization, more and more grants could be provided in the form of general and unconditional grants. Some grants also could be given as matching grants, which means that both the donor and the recipient governments would finance specified percentages of the expenditures on certain services. Such matching grants should depend upon expenditures or tax levels. Since they rise with an increase in local expenditure, they work as a subsidy and might encourage overspending. At the same time, matching grants encourage local governments to put in more effort to raise tax revenue.

Borrowings

Local governments can also generate resources through borrowing. This source could be used to finance the capital outlays for those services that involve huge investment in long-lasting infrastructure such as public utilities and road infrastructure.[43]

Local government, however, should not be encouraged to make excessive use of borrowing. It is to be noted that local governments are viewed as a particularly risky investment. Unlike private commercial borrowers, they lack marketable collateral. Local revenue-raising ability is constrained by central regulations and local political pressure, and continuity of management is unlikely. "Under these conditions, even if long-term private savings were available, local governments would likely remain shut out of the domestic capital market."[44]

Except for a few municipalities, which have taken loans from the Town Development Fund, the Nepalese local governments have not used borrowings. The Town Development Fund is an autonomous body established in 1996 with the participation of the Nepalese government, the German government, and the World Bank. It provides grants and loans to the municipalities. A few municipalities have taken loans from this body to carry out such projects as funding shopping complexes, bus parks, local roads, storm water drainage, and vegetable markets. The status of municipal loans is given in Table 6.

Table 6. Status of Municipal Loans

Fiscal year	***Rs in millions of 1983/84 prices***
1994/95	10
1995/96	30
1996/97	6
1997/98	5

Source: Urban Development through Local Efforts (UDLE), "Detailed Revenue and Expenditure Breakdown and Basic Financial Information of 58 Municipalities (FY 1994/95-1997/98)," Kathmandu.

Since the Nepalese local governments are not indebted, there is no question of debt service. The new law allows for borrowing. But it should be viewed cautiously. It should not be made too easy for the local governments to take loans. It is politically easier to borrow than to collect taxes. Some borrowing might be necessary and justified. But excessive borrowing could lead to a difficult situation in the future. This is because local government would be required to pay high debt service charges, precluding them from providing other normal services.

Detailed regulations need to be prepared regarding the borrowing by the local governments. Criteria and conditions should be fixed. Approval of the central government in certain cases or in cases above a certain level may be required. Loans should not exceed a certain percent of the total capital expenditure of the local government. However, self-financing projects (where fees and charges can be raised) may be exempted from the rule. Local government should try to finance self-financing projects (but not other types of projects) through borrowing. Loans may be more of a special interest to municipalities than to other local bodies due to the high demand for public services in municipal areas. The regulations relating to loans should take the municipal conditions into account.

Concluding Observations

Local governments are created in low-income countries (as they are in higher-income countries). These bodies are expected to manage local affairs in an efficient way, since they know the needs of the local people and can identify the preferences of their voters. It is easy for them to tailor programs to the needs of their local area. Those public functions, in particular, which are limited to the boundary of the local government, can be managed more efficiently when the government is close to the people it governs.

Local governments are authorized to collect user charges if it is possible to identify the beneficiary. They are also empowered to levy such taxes as property taxes, frontage taxes, vehicle taxes, entertainment taxes on fairs, and markets and poll taxes. However, in many low-income countries, since local governments do not generate much revenue from their own sources, they depend largely on transfers from the central government to meet their expenditure needs. But large transfers from central to local might induce local governments to underutilize their own tax bases. To avoid this, the grant system should also be designed in such a way that it encourages local governments to put more effort into tax administration and collection. This is always easy to say but very difficult to design in a country like Nepal. It is also necessary to consider that there are backward regions and regions with poor resource bases, which need more grants than others. This demands some lump-sum grants, which will ensure that all regions can provide a specified level of public services at the same tax rate. Receipts of lump-sum grants are not required to match the funds supplied by the donor government.

While local governments in Nepal have been made responsible for providing many public services, they have provided only a few services using centrally transferred money. In general, these bodies are weak and do not carry out assigned functions. Many functions, including education, health, road, security, etc., which are performed by the local governments in many countries, are performed by the central government in Nepal.

The fiscal position of the local government in Nepal is far from satisfactory. While local governments have been authorized to levy some taxes, they have largely not used the revenue-generating authority assigned them by the law. They depend mainly on the central government transfer to meet their expenditure needs which can undermine the autonomy and vitality of decentralized decision making and induce local governments to underutilize their own tax bases. It is necessary to design the grant system in such a way that local governments, which put more effort into raising taxes, are rewarded.

Local governments are not able to generate sufficient financial resources to finance their activities. Their capacity to raise revenues needs to be increased significantly. It is, therefore, necessary to initiate major reforms in the administration and management of the affairs of the local governments, particularly in the municipalities—which are growing fast and where the demand for public services has been increasing rapidly. To this end, it would be desirable to introduce incentives and disincentives to the transfer system and to make every effort to utilize limited resources efficiently. An appropriate system of responsibility and accountability needs to be set up so that the possibilities for misuse of public funds will be reduced. Substantial efforts need to be made in all areas of revenue administration and management in order to achieve this goal.

Appendix 1. Local Public Sector Responsibility for Urban Services: Cities with Moderate Local Responsibility

Functions	Thailand Bangkok	Pakistan Karachi	India Madras	Philippines Manila	Morocco Casablanca	Zambia Lusaka	Colombia Cartagena	Mexico Mexico City
Public Utilities								
Water Supply	P	P	P	P	P	P	P	P
Sewerage, Drainage	P	P	P	P	P	P	P	P
Electricity	N	N	N	N	N	N	N	N
Telephones	N	N	N	N	N	N	P	N
Social Services								
Primary Education	P	S	P	S	N	N	S	N
Health	P	P	S	S	S	S	N	S
Social Welfare	N	S	S	S	S	S	N	S
Housing	N	N	S	S	N	P	N	N
Transportation								
Highways, Roads	N	P	P	S	P	P	P	P
Street Lighting	N	P	P	S	P	P	P	P
Mass Transport	S	N	N	N	P	N	N	N
Gen. Urban Srvcs.								
Refuse Collection	P	P	P	P	P	P	P	P
Parks and Recreation	P	P	P	S	P	P	P	P
Markets and Abattoirs	P	P	P	P	P	P	P	P
Cemeteries	P	P	P	P	P	P	P	P
Fire Protection	P	P	P	P	S	P	P	na
Law Enforcement	N	N	N	N	S	N	N	S

P - Primary responsibility; S - Secondary responsibility; N - No responsibility

Source: Johannes F. Linn and Roy W. Bahl, "The Assignment of Local Government Revenues in Developing Countries." Paper prepared for the ISPE Conference on Taxation in Federal Systems held at the Center for Research on Federal Financial Relations, Canberra, August 25-27, 1982, p. 44.

Appendix 2. Major Functions of Local Governments in Nepal as Specified under the Local Self-Governance Act 1999

VDCs' functions relating to:

a)	Health service	:	Health centers, health posts, sub-health posts, family planning and child care
b)	Education and sports	:	Pre-primary schools, primary education in mother tongue, adult education, libraries, and sports
c)	Language and culture	:	Religious places, rest houses, and inns
d)	Works and transport	:	Tracks and trails, rural roads, bridges, twines and culverts;
e)	Drinking water	:	Drinking water projects, wells, deep water, ponds, and taps
f)	Agriculture	:	Agricultural development programs, agricultural weekly/ temporary markets and fairs, and veterinary hospitals
g)	Irrigation, soil erosion, and river control	:	Irrigation, dams, canals, water channel, soil erosion, river control, and electricity
h)	Physical development	:	Community buildings, rest houses, public toilets, land utilization plans, sewerage and drainage
i)	Forests and environment	:	Forestation, soil conservation ,and environment protection
j)	Tourism and cottage industries	:	Tourist areas and cottage industries

Municipalities' functions relating to:

a)	Health	:	Municipal-level hospitals, Ayurvedic dispensaries, health centers, health posts, family planning, mother and child welfare, epidemics, and infectious diseases
b)	Educational sports	:	Pre-primary schools, primary education, adult education and

			informal education, libraries, reading halls, and sports
c)	Culture	:	Archaeological objects, languages, religion, and culture
d)	Social welfare	:	Cremation of heiress, dead person, and orphanages
e)	Physical development:		Housing plan, drinking water, drainage, green zones, parks, recreational areas, public toilets, community building, and rest houses
f)	Works and transport	:	Municipal roads, bridges, converts, and bus parks
g)	Industry and tourism	:	Cottage, small and medium industries, natural, cultural and tourists heritage
h)	Water resources, environment and station	:	Rivers, streams, ponds, deep water, wells, lakes, river cutting, floods and soil erosion, water, air and noise pollution, sanitation, garbage, and solid wastes

DDCs' functions relating to :

a)	Education and sports	:	Schools, adult and informal education, sports and physical development
b)	Health service	:	District level health posts, hospitals, Ayurvedic dispensaries, health centers, health offices, family planning, mother/child welfare, extensive vaccination, nutrition and population education, and public health
c)	Rural drinking and habitation development:		Rural drinking water projects covering more than one VDC, habitation and market development
d)	Language and culture :		Culturally and religiously important places, languages, religions and culture, archaeological objects, languages, religion, art, and culture
e)	Women and helpless people	:	Women, orphans, helpless women, the aged, disabled, and

			incapacitated
f)	Works and transport	:	District level roads, suspension bridges, and license to “D” contractors
g)	Irrigation, soil erosion, and river control	:	Irrigation, ditch, embankment covering (more than one), VDC, soil erosion, and river cutting
h)	Agriculture	:	Agriculture and livestock, seeds, fertilizers and other agricultural inputs, agriculture extension, and agricultural weekly markets/fairs
i)	Land reforms and management	:	Unregistered land and government barren land
j)	Hydropower	:	Mini and micro hydropower and other energy
k)	Forest and environment	:	Forests, vegetation, biological diversity, soil conversation, and environment
l)	Wages	:	Wages and abolition of child labor
m)	Information and communication	:	Cinema, district level libraries, reading rooms, and information centers in rural areas;
n)	Cottage industry	:	Cottage industries and industrial zone
o)	Tourism	:	Natural, cultural, historical, and touristic heritage.

Appendix 3. Revenue Allocation Characteristics

	Choice of Base	Choice of Rate	Administration Responsibility	Revenue Flows Based on
Independent Local Taxation	Local	Local	Local	Local Tax Base
Centrally Assisted Local Taxation	Local	Local	Local/Center	Local Tax Base
Local Surcharge	Center	Local	Center	Local Tax Base
Tax Sharing	Center	Center	Center	Local Tax Base or Formula Basis
Revenue Sharing	Center	Center	Center	Formula Basis

Source: Harvard University, "Tax Reform in Nepal: A Comprehensive Review," Final Report, Harvard University, Cambridge, MA, 1997, p. 231.

Appendix 4. Advantages and Disadvantages for Revenue Allocation Methods

METHOD	ADVANTAGES	DISADVANTAGES
Independent Local Taxation	Local Choice of Tax Rate Local Choice of Tax Base Local Control of Administration	Duplicate Administration Admin./Compliance Costs No Equalization Possible Inter-Regional Distortions from Differential Base and Rates
Centrally Assisted Local Taxation	Local Choice of Tax Rate Local Choice of Tax Base Reduced Admin./Compliance Costs	No Equalization Possible Inter-Regional Distortions from Differential Base and Rates
Local Surcharge	Local Choice of Tax Rate Uniform Tax Base Unified Administration	No Choice of Tax Base No Equalization Possible Inter-Regional Distortions from Differential Rates
Tax Sharing	Uniform Tax Base Unified Administration	No Choice of Tax Base No Choice of Tax Rate No Equalization Unless Distributed by Formula
Revenue Sharing	Uniform Tax Base Unified Administration Equalization Option	No Choice of Tax Base No Choice of Tax Rates

Source: Harvard University, "Tax Reform in Nepal: A Comprehensive Review," Final Report, Harvard University, Cambridge, MA, 1997, p. 231.

Appendix 5. Efficient Assignment of Local Revenue Authority
Classified by Type of Expenditure Responsibility

Services	Sources of Finance[a]			
	Local Taxes	User Charges	Transfers	Borrowings[b]
Public Utilities				
Water Supply	S	P		
Sewerage	S	P		A
Drainage	P	P[c]		A
Electricity		P		A
Telephone	S	P		A
Markets and Abattoirs	S	P		(A)
Housing		P		A
Land Development		P		A
Transportation				
Highways and Streets	P	P[c]		A
Public Transit	S	P		(A)
General Urban Services				
Refuse Collection	P			(A)
Parks and Recreation	P			(A)
Fire Protection	P			(A)
Law Enforcement	P		S	
General Administration	P			
Social Services				
Education	P		P	
Health	P	S	P	(A)
Welfare	S	S	P	(A)

a) P – Primary Sources; S – Secondary Sources
b) A – Borrowing is appropriate for major capital expenditures
(A) – Borrowing is appropriate for capital spending, but likely to account for small share of total spending.
c) Development charges (i.e., special assessment, valorization charges, etc.) are appropriate for these services especially where benefits are spatially well defined within a jurisdiction.

Source: Johannes F. Linn and Roy W. Bahl, "The Assignment of Local Government Revenues in

Developing Countries," Paper prepared for the ISPE conference on Taxation in Federal Systems held at the Center for Research on Federal Financial Relations, Canberra, August 25–27, 1982, p. 7.

Appendix 6. Fiscal Position Local Governments
(1997/98)

Description	Rs in millions of 1983/84 prices
Total Expenditure	**1,592**
DDCs	251
Municipalities	211
VDCs	1,130
Total Tax Revenue	**453**
DDCs	11
Municipalities	266
VDCs	176
Total Nontax Revenue	**609**
DDCs	65
Municipalities	86
VDCs	458
Total Grants	**732**
DDCs	175
Municipalities	38
VDCs	519
Total Loans	**5**
DDCs	-
Municipalities	5
VDCs	-

Source: Income and expenditure statements of all municipalities and selected DDCs and VDCs.

Endnotes

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[1] D. A. L. Auld, "The Efficiency Criteria for Local Government Revenue: An International Comparison." Occasional Paper No. 37, Center for Research on Federal Financial Relations, Canberra: Australian National University, 1986, p. 1.

[2] Alison Martin and W. Arthur Lewis, "Pattern of Public Revenue and Expenditure," *The Manchester School of Economic and Social Studies* 24, September 1956, p. 231. Extracted from Wallace E. Oates, "Fiscal Decentralization and Economic Development," *National Tax Journal* 46(2), 1993, p. 237.

[3] Wallace E. Oates, op. cit., p. 238.

[4] Ibid., p. 237.

[5] There are several VDCs and a few municipalities in one district. There are, however, no municipalities in some districts that are located in the northern part of Nepal.

[6] William Dillinger, "Decentralization, Politics, and Public Services," World Bank, Washington, D.C., June 1995, p. 12.

[7] See Roy Kelly, "Intergovernmental Revenue Allocation Theory and Practice: Application to Nepal," *Asian Journal of Public Administration* 21(1), 1999, for more details.

[8] D. A. L. Auld, op. cit., p. 2.

[9] See Horst Zimmermann, "Local Government Finance in Nepal: Options for Reform" (unpublished paper prepared for the High Ranking Decentralization Co-Ordination Committee, Decentralization Working Committee, and GTZ Project on Urban Development Through Local Efforts," October 1996) for further details on the broader intergovernmental fiscal issues in Nepal.

[10] Anwar Shah, "The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies," Policy and Research Series 23, World Bank, Washington, D.C., 1994, p. 11.

[11] John Norregaard, "Intergovernmental Fiscal Relations," in *Tax Policy Handbook*, edited by Parthasarathi Shome, International Monetary Fund, Washington, D.C., 1995, p. 248.

[12] John Norregaard, op. cit., p. 248.

[13] Richard M. Bird, Intergovernmental Finance and Local Taxation in Developing Countires: Some Basic Considerations for Reformers, *Public Administrtion and Development* 10, 1990, p. 280.

[14] Salley Hey and Miguel Urrutia, "The General Characteristics and Situation of the Departments and Municipalities," in *Fiscal Reform for Colombia*, edited by Malcolm Gillis. The Law School of Harvard University, Cambridge, MA, 1971, p. 724.

[15] Horst Zimmermann, "Strengthening Local Government Finance: Principles of Fiscal Decentraliztion and Nepal Case Study," Deutsche Gesellschaft fur Technische Zusammernarbeit (GTZ), Eschborn, 1998, p. 41.

[16] Johannes F. Linn and Roy W. Bahl, "The Assignment of Local Government Revenues in Developing Countries." Paper prepared for the ISPE Conference on Taxation in Federal Systems held at the Center for Research on Federal Financial Relations, Canberra, August 25–27, 1982, p. 6.

[17] Jeorgen R. Lotz, "Local Government Taxation: Recent Trends and Issues," in *Reforms of Tax Systems*, edited by K. W. Roskamp and F. Forte, Wayne State University Press Detroit, 1981, p. 238.

[18] Ibid., p. 235.

[19] Arthur B. Gunlicks, *Local Government in the German Federal System*, Duke Press Policy Studies, Duke University Press, Durham, 1986, p. 120.

[20] Raja J. Chelliah and Om Praksah Mathur, "Operationalising Article 243 Y of the Constitution (Seventy-Fourth) Amendment," National Institute of Public Finance and Policy, New Delhi, March 1995, p. 10.

[21] However, in China local governments collect most taxes and these are shared-up to higher levels. For details see Roy Bahl, "Evaluating the Impact of Intergovernmental Fiscal Reform in China," School of Policy Studies, Georgia State University, January 1997, p. 8.

[22] Anwar Shah, op. cit., p. 23.

[23] Ibid., p. 2.

[24] Organization for Economic Co-operation and Development (OECD), "Taxes on Immovable Property," Paris, 1983 p. 17.

[25] Angela Fraschini, Franco Osculati, and Mario Rey, "Addendum-Local Autonomy, Accountability, and a New Local Tax: The Italian Debate," in *Local Business Taxation: An International Overview*, edited by Giancarlo Pola, Vita E. Pensiero, 1991, p. 226.

[26] Anwar Shah, op. cit., p. 2.

[27] Jeorgen R. Lotz, op. cit., p. 246.

[28] Richard M. Bird, op. cit., p. 284.

[29] Roy Bahl, "Fiscal Decentralization: Lessons for South Africa," unpublished manuscript, 1994, p. 11.

[30] Raja J. Chelliah and Om Prakash Mathur, op. cit., p. 7.

[31] Until early 1999, municipalities were authorized to levy house roof tax, rent tax, vehicle tax, professional and business tax, and octroi. Similarly, VDCs were allowed to collect house roof tax, vehicle tax, and shops and weekly market tax. DDCs were authorized to impose tax on wool, turpentine, herbs, roads, bridges, and canals under their area of jurisdiction.

[32] Taxes assigned to the local governments under the Local Self-Governance Act are as follows:

VDCs: land revenue, house and land tax, market shop tax, vehicle tax, entertainment tax, rent tax, advertisement tax, professional tax, commercial video tax, and natural resources utilization tax.

Municipalities: land revenue, house and land tax, rent tax, professional tax, vehicle tax, unified property tax, entertainment tax, commercial video tax, and advertisement tax.

DDCs: taxes on road, bridges, irrigation, ditches, ponds, wool, turpentine, herbs, stones, slates, sand, bones, horns, wigs, and leather.

[33] Horst Zimmermann, op. cit., p. 20.

[34] National Institute of Public Finance and Policy Redefining State-Municipal Fiscal Relations: Options

and Perspectives for the State Finance Commissions, Volume 1, Main Report, May 1995, p. 32.

[35] Johannes F. Linn and Roy W. Bahl, op. cit., pp. 5–6.

[36] Raja J. Chelliah and Om Prakash Mathur, op. cit., p. 9.

[37] Kamlesh Misra, "Issues in Devolution of Functions and Fiscal Powers to Municipalities," National Institute of Public Finance and Policy, New Delhi, 1995, p. 26.

[38] Johannes F. Linn and Roy W. Bahl, op. cit., p. 23.

[39] William Dillinger, op. cit., p. 8.

[40] Ibid., p. 9, and Raja J. Chelliah and Om Prakash Mathur, op. cit., p. 11.

[41] Johannes F. Linn and Roy W. Bahl, op. cit., p. 6.

[42] William Dillinger, op. cit., p. 8.

[43] Johannes F. Linn and Roy W. Bahl, op. cit., p. 6.

[44] William Dillinger, op. cit., p. 10.